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August 4, 2003

Honorable Stephen L. Vagnini,
Assessor, Monterey County
P.O. Box 570
Courthouse
Salinas, CA 93902
Attn: Steve Vilcone, Appraiser

Re: Trust Property Transfers – Application of Parent-Child Exclusion to Non ProRata Distribution

Dear Mr. Vagnini:

This is in reply to your letter of April 22, 2003 in which you relate questions from Mr. requesting an opinion concerning the application of the parent-child exclusion to the distribution of real property from a trust to beneficiaries who are the children of the settlor in which the trustee proposes to make non prorata distribution of the property. The trustee proposes to obtain a loan in order to equalize the dollar value of distributed interests to the beneficiaries. For purposes of applying the exclusion, you ask whether the loan to the trust may be obtained from the beneficiary to whom the real property will be distributed rather than from a third-party lender. For the reasons set forth below, a loan made by the beneficiary would be considered payment for the other beneficiary's interest in the trust property distributed to the lender which would constitute a transfer of that interest, in effect, constituting a "purchase" by the lender/beneficiary from the other beneficiary. Thus, the parent-child exclusion would not be applicable to exclude the transfer of the other beneficiary's interest in the real property from a change in ownership.

Facts Presented

A trust has a single asset, a piece of real property called Blackacre, worth \$100,000 that is to be distributed equally to the two beneficiaries who are the children of the trustor. The trustee has the power under the terms of the trust instrument to make non prorata distributions of the trust property. In order to make a non prorata distribution of the property to A, it is proposed that the trustee will obtain a \$50,000 unsecured loan from A. The trustee will distribute the \$50,000 to B and Blackacre to A encumbered by the obligation to repay the loan. Alternatively, A would lend the trust the \$50,000 secured by a note and deed of trust on Blackacre. The trustee then distributes the \$50,000 to B and Blackacre to A subject to the note.

Law and Analysis

Revenue and Taxation Code section 63.1 implements section 2, subdivision (h) of article XIII A of the California Constitution and generally provides for an exclusion from change in ownership for certain transfers of real property between parents and their children. Subdivision (c)(9) defines “transfer” to include “any transfer of the present beneficial ownership of property from an eligible transferor to an eligible transferee through the medium of an inter vivos or testamentary trust”. Therefore, if the transfer of the decedent’s property to the decedent’s son qualifies as a transfer from the decedent pursuant to the terms of his trust, then the transfer qualifies for exclusion from change in ownership under section 63.1.

Unless the trust instrument specifically states otherwise, the trustee has the power under Probate Code section 16246 to distribute the trust assets in kind on either a pro rata or non prorata basis. A trustee with the power to distribute the trust property on a non prorata basis may allocate specific assets to individual beneficiaries so long as the value of their shares are equal. Thus, the transfer of an undivided interest in real property is considered a direct transfer from the trustor to the beneficiary to the extent that the value of the property interest does not exceed the value of the beneficiary’s share of the trust estate. Accordingly, such a distribution from a trustor-parent to a beneficiary-child constitutes a transfer of real property that may qualify for the parent/child exclusion under Section 63.1. (Letter to Assessors No. 91/08.)

Under the facts presented, the trustee also has the power to encumber the trust property by using the property as security for a loan. It is our view that a trustee who elects to make a non-prorata distribution of trust properties which are not of equal value, may encumber property by securing a loan and distribute the proceeds of the loan to the other beneficiary or beneficiaries in order to equalize the values of the shares of distributed property. (See Annotated Letter No. 625.0201, enclosed) Additionally, the encumbrance on the property must be considered in determining the value of the share of the beneficiary who receives that property.

However, a money contribution by a beneficiary of the trust in order to equalize the shares of the beneficiaries for the purpose of trust distribution constitutes payment for the interest of the other beneficiary, in effect, a “purchase,” even though it may be characterized as a loan. “A loan transaction contemplates a debtor-creditor relationship with an obligation of the ‘debtor’ to repay the amount of the loan to the creditor.” *Ghirardo v. Antonioli* (1994) 8 Cal.4th 791 (quoting 4 Miller & Starr, *supra*, § 10:3, p. 651.). A security transaction in real property creates an interest in realty to secure the performance of an obligation. 3 Witkin, Summary of California Law sections 1, p 515. Thus, a security transaction involves at least two parties in which a debtor gives a creditor a lien on the debtor’s property as security for an obligation owed to the creditor. Witkin section 5, p 517.

Under first scenario, the trust borrows \$50,000 from beneficiary A which is secured by a note and deed of trust in Blackacre. The trust distributes Blackacre to A subject to the note and gives the \$50,000 to beneficiary B. The transfer does not constitute a secured loan transaction because it involves only one party, A. Moreover, no interest is created in Blackacre to secure the performance of an obligation because A is the obligor on the note.

Under the second scenario, A makes an unsecured loan of \$50,000 to the trust. The trustee distributes the \$50,000 to B and the Blackacre to A with the obligation to repay the loan.

The transfer from A does not constitute an unsecured loan transaction because A is both debtor and creditor and, of course, has no obligation to repay a loan to himself.

Thus, A's contribution of money to the trust is not a loan transaction because it does not create a debtor-creditor relationship whereby a B either assumes an obligation to repay the debt or gives A, security interest in the debtor's property. Instead, the money tendered by A would be paid directly to B and in exchange A will receive the real property interest of B, in effect, constituting a purchase of B's interest by A. The transfer of B's interest to A in exchange for A's payment results in a change in ownership for which the parent-child exclusion under section 63.1 is not applicable.

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Very truly yours,

/s/ Kristine Cazadd for L. Ambrose

Lou Ambrose
Supervising Tax Counsel

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cc: Mr. David Gau, MIC: 63
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